9-2005

School Finance Reform and Property Values, Part 2: Public Service Capitalization

John Yinger
The Maxwell School, Syracuse University, joyinger@syr.edu

It's Elementary

A Monthly Column by EFAP Director John Yinger
September 2005

School Finance Reform and Property Values,
Part 2: Public Service Capitalization

The main point of education finance reform is to improve student performance in disadvantaged school districts. A successful school finance reform therefore makes disadvantaged school districts more attractive to homeowners and boosts the value of homes in those districts. The link between school performance and property values is called public service capitalization. This column discusses the evidence about public service capitalization and the implications of this phenomenon for the design of an education finance reform program.

Most people who have searched for housing recognize that they will have to pay a premium to buy a house in one of the best school districts. Nevertheless, public service capitalization is not an easy phenomenon to document because the role of school quality (or of other local public services) must be isolated from many other factors that affect house values. Fortunately, however, this phenomenon has attracted the attention of many scholars and several high-quality studies demonstrate that, all else equal, the sales price of a house is higher in a school district where student performance is high than in a district where student performance is low.

This evidence shows that households compete for entry into the most desirable school districts. Because higher-income households will win this competition under most circumstances, the existence of public service capitalization implies that higher-income people will tend to live in better school districts than lower-income people. This process is self-reinforcing, because a concentration of lower-income people means that a district has fewer resources and more disadvantaged students than other districts—both of which contribute to poor school performance.

As a result, public service capitalization helps to explain why education finance reform is often needed. The market process that allocates households to school districts leads to a situation in which children in low-income households systematically end up in lower-performing school districts than do children in higher-income households. State policy, typically in the form of compensatory education aid, is therefore needed to ensure that all students have access to the type of education specified in a state's constitution.

The existence of public service capitalization also implies that education finance reform, or any other state policy that affects school performance, has unanticipated equity consequences. To be specific, a compensatory education aid program results in capital gains for homeowners in the neediest districts and might lead to capital losses for homeowners in the least needy districts. These gains and losses arise only for homeowners at the time the reform is announced. The flip side of the capital gain for current owners in disadvantaged districts is that future owners in those districts will have to pay more for housing.

Education finance reform also affects renters, but in a very different way, namely by raising rents in disadvantaged school districts. Renters with school-age children experience an increase in school performance along with this rent increase, so that, on balance, they are not harmed by the reform. Policy makers may nevertheless be concerned about the impact of rent increases on other households in these districts.

To some degree, the gains and losses for current homeowners may be seen as compensation for the prior education finance policies that created the need for education finance reform. After all, the values of houses in a school district are depressed when that district does not receive the state aid to which it is entitled according to the state's constitution. Reform-induced capital gains to long-term homeowners in this district therefore seem fair. Nevertheless, gains and losses for recent homebuyers and the rent increases for childless household do not seem fair and should be acknowledged as part of the price of education finance reform.

Some scholars have pointed out that, in principle, public service capitalization can result in an unusual feedback between compensatory aid and property values. School districts with lower property values receive more compensatory aid, which leads to an increase in their school performance and hence to an increase in their property values. If this property value increase feeds back into the state aid formula, it may therefore undermine the intent of the compensatory aid program. As it turns out, however, this type of feedback effect does not arise with a foundation aid formula, which is the type of formula used in most recent education finance reforms. Although foundation aid does raise property values in the most disadvantaged districts, it does not raise these values enough to alter either the set of districts eligible for aid or the impact of the aid program on student performance.

Overall, the main objective of recent education finance reform efforts around the country has been, as it should be, to improve the quality of the education provided to children in the most disadvantaged school districts. Education finance reform also has complex impacts on households, however, as well as on children. These impacts on households may include rent increases and capital gains for current homeowners in disadvantaged districts and capital losses for current homeowners in wealthy districts. Policy makers may want to consider these impacts when they decide how to pay for education finance reform.